# JAMESSON ASSOCIATES

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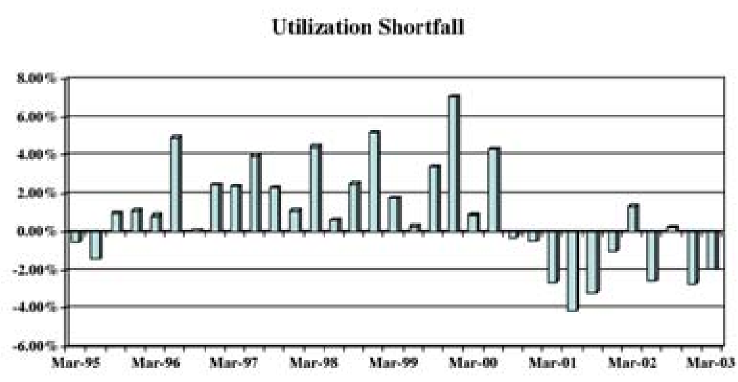
## Recent Economic Events

The American economy continues to stumble along like a drunk making his way home at 2 AM. Most of the time he'll arrive safe and sound, but every once in a while he'll slip, fall, and sleep it off on the street. (Apologies to female readers for using the male pronoun.) Our bartender, Mr. Bush, and his supplier, Mr. Greenspan, figure the best cure is a little "hair of the dog."

GDP increased by an upwardly revised 1.9% in the first quarter. This marks the second consecutive quarter and the ninth out of the last eleven quarters with sub-3% growth. Almost everyone agrees that the economy has to grow by at least 3% to make any headway in reducing unemployment or idle capacity. The shortfall in utilizing these resources is known as the output gap. I have created my own measure. It captures the quarterly GDP change versus the average growth over the preceding ten years and adds it to the difference in unemployment versus the ten-year average. I term the resulting measure the Utilization Shortfall. Logic suggests that when we aren't using the resources available, price pressure is downward.




While we were positive (using up resources) from 1997 to 2000, inflation rose from 2.1% to 3.4%. Since negative bars appeared, the rate has declined back to 1.6%. Until we become positive again, we can't put the specter of deflation completely out of our minds.

In May, the US economy was operating at 74.3% of capacity, unchanged from April. Help-wanted advertising hit another new all-time low of 35 in April. A forward-looking report from Manpower Inc. found that hiring intentions for the third quarter of 2003 were the weakest in 12 years.

The official employment report for May showed unemployment at a new post-expansion high of 6.1%, and more discouragingly, the average non-farm work week fell to a new low of 33.7 hours. Three years ago, this measure registered 34.4 hours. This 2% decline takes income out of workers' hands and serves to compound the pressure of actual layoffs.

Congress passed and the President signed new legislation reducing taxes in an attempt to help the economy grow. The third quarter should see a significant portion of the stimulus as both reduced withholding schedules and child credit rebate checks hit the system. Combined with this "more of the same" on the fiscal front, the

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## Recent Economic Events (continued)

Federal Reserve has signaled its intent to fight deflation with the same vigor it applied to the inflation battle.

Figuring that interest rates were not quite low enough to encourage another round of refinancing, Mr. Greenspan aired his concerns over "the probability of an unwelcome substantial fall in inflation." Mortgage rates subsequently hit new lows and the refinance index is testing its all-time high again. A concern: as of the end of 2002, homeowners had a record low level of equity (market value less mortgage balance) left in their homes in spite of three years of substantial housing price inflation. Homeowners' equity of only 55.4% and elevated ratios of selling prices to replacement costs suggest that this refinance wave may be the last one for some time.

Fortunately, the most recent inflation reports indicate some stabilization in the relentless downward pressure on prices. Producer prices in total fell .3% in May but were up .1% on a core basis. Over the last year, prices are up 2.5% at the producer level. The May CPI report indicated that headline inflation was unchanged while core inflation increased an unexpected .3%. The acceleration in the core rate appears to be related to a record increase in hotel rates. This is a bit puzzling given the decline in travel being reported. Nevertheless, year-to-date inflation statistics continue to show a declining trend in inflation and the still sizable trade deficit keeps competitive price pressures at the forefront. (Even though the dollar has declined in the foreign exchange markets, it turns out that there is no respite for those who compete against China. The Chinese peg their currency to the dollar.)

The drunk staggers on toward home, a comfy bed, and full recovery. To speed him on his way, he has been slipped an extra twenty (tax cuts) and a shot of whiskey (lower rates). Let's hope he makes it without mishap, but let's also keep in mind we haven't addressed the inevitable hangover (debt and deficits).❖

## Commentary

The US should not be involved in nation building; we can't be the world's policeman.

There is an axis of evil made up of Iran, Iraq, and North Korea.

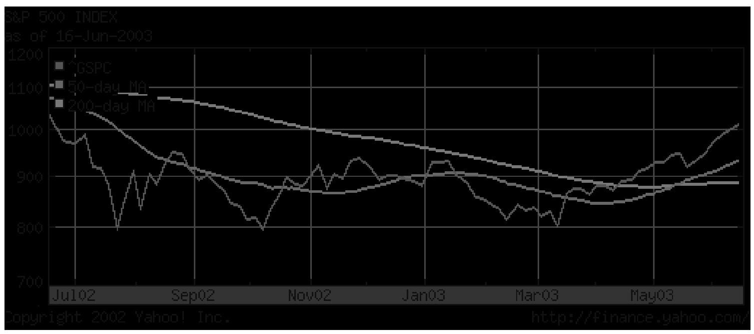
Saddam Hussein's weapons of mass destruction must be destroyed. He is close to having nuclear capabilities and clearly has significant stockpiles of chemical and biological weapons. He is a threat to all of his neighbors.

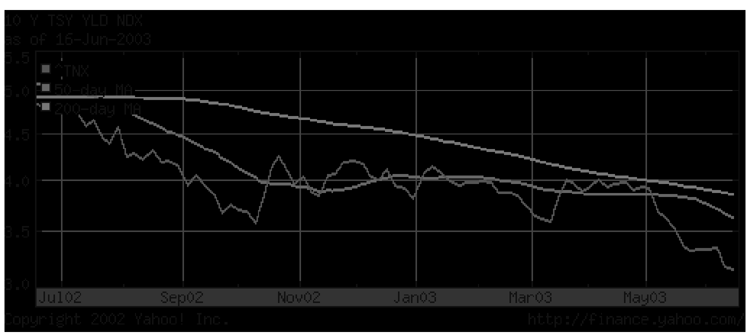
The US-led war in Iraq began on March 20th. Organized military resistance was minor and hostilities ended 26 days later on April 15th. To date, no weapons of mass destruction have been uncovered.

The reconstruction of Afghanistan has stalled 18 months after US forces toppled the Taliban.

The reconstruction of Iraq is up to 60 days and counting. There is no timetable for turning the process over to Iraqis.❖

The charts on this page show movement in both the stock and bond markets. Until earlier this year, you could have substituted a bond yield chart for a stock market chart, and no one would have been the wiser. When the stock market rallied, bond yields rose and vice versa. But in May, the charts morphed into mirror images.




What is one to make of this? There are three possibilities: everyone is right, someone is wrong, everyone is wrong.

Let's start with the scariest possibility. What if both markets are wrong? That requires the economy to roll over into either a recession or worse, stymieing the incipient improvement in corporate profits. However, at the same time, interest rates would have to rise, killing bond investors. We've seen this before: stagflation. Welcome back Kotter (okay, Carter, but I couldn't resist), a 20% misery index, and gasoline lines. The probabilities of this happening in the near future are quite slim.

Can both markets be right? For true believers in the efficiency of the invisible hand, this is the expected outcome. We need to anticipate an extended period of time with low but positive inflation, allowing borrowers to expand and hire. This will generate a sustained increase in demand for goods produced. Better dust off the "I like Ike" buttons if you are betting on this outcome.

Being a bit more cynical, I believe that one of the markets is being carried along more by emotion or manipulation than it is following a sustainable course. Two possibilities exist. If the stock market is accurately reflecting the future, the Fed and the administration will be successful in stimulating the economy. Inflation will build, allowing companies some pricing flexibility to improve profits. Demand for funding from business will collide with the need to cover half-trillion dollar Federal deficits, pushing up interest rates in response. The fly-in-the-ointment in this scenario is the high level of debt presently existing in the American economy. Total domestic debt now exceeds three times GDP. This is higher than the last comparable peak in the 1930's, higher than it was in the aftermath of fi-

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## Market View (continued)

nancing World War II, and in fact higher than at any time in my records. It's this overhang that will prove the undoing of this scenario. It limits the Federal Reserve's ability to raise rates, creating the environment for stagflation-redux.

*This suggests that ... the concerns over deflation are real...*

If the bond market is right, but the stock market is not, then the future plays out with a continued slow-growth economy — maybe even a recession. This suggests that the Fed is not simply manipulating the bond market lower, but rather the concerns over deflation are real, and it will take a while before we can overcome the headwinds. It's hard to make money in that environment, so stock market gains will remain tenuous.

Not a bad exposition in the possibilities my dear Watson, but which is correct? I think the last scenario has the highest probability. The both-wrong case is too scary; the both-right requires too much luck. Stocks right and bonds wrong contains the seeds of its own destruction because of high debt levels.

Since the stock market has been as strong as it has, I am reluctant to leave it altogether. As I recommended last time, I would use the rally to lighten up on riskier stocks. Of course, had you taken my advice last time, you would have exited these stocks in favor of bonds. This time my advice factors in the strong momentum in stocks. I would be inclined to let profits run on using a stop at about 925 to 950 on the S & P 500 as the trigger for exit. Raise the stop as the market rallies beyond its present level of about 1000. Keep your dividend paying stocks (lower taxes help too) as core holdings, and look to add to bond positions if the ten-year Treasury moves back to the 3.50% to 3.75% area. If I am wrong, a breach of 4% on the ten-year will signal that inflation, profitability, and stock market gains have returned.❖

## Editor's Note

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I should have known. "The first casualty of war is truth." By describing the then reported accounts of the Jessica Lynch story, I fell into the trap of wanting to believe the best. So be it. The second chapter of this story has yet to be written, but it now appears that much of what is known falls into the category of uncorroborated information. However, those reporters who were snookered are fully involved with trying to find the truth if it can be found. What a welcome change from defensive rationalizations at *The New York Times*, secret investigations of exaggerated intelligence reports of WMD, or outright lying about company prospects by stock analysts. Even with all the warts, I'll stick with the fourth estate when I have to make my choice on whom to believe.❖